

RD AN No. 3882 (4279-B)
July 11, 2003

SUBJECT: Business and Industry Guaranteed Loan Program
Biobased Products Manufacturing Proposals

TO: State Directors, Rural Development

ATTN: Business Programs Directors

PURPOSE/INTENDED OUTCOME:

The Farm Bill Energy Title has highlighted ethanol and other biobased products as a means of promoting rural economic development, providing a biobased energy source, and protecting the environment.

The purpose of this Administrative Notice (AN) is to provide guidance on how current regulations impact proposals seeking Business and Industry (B&I) Guaranteed Loan financing for the production and marketing of biobased products other than food or feed (e.g., fuels, chemicals, or electricity) that use biological products, renewable forestry, or agricultural materials (including plant, animal, or marine materials). The explanations contained in this AN apply to businesses primarily involved in the manufacturing of biobased products, including but not limited to ethanol, biodiesel, and biobased lubricants.

COMPARISON WITH PREVIOUS AN:

There is no previous AN on this subject.

EXPIRATION DATE:
July 31, 2004

FILING INSTRUCTIONS:
Preceding RD Instruction 4279-B

IMPLEMENTATION RESPONSIBILITIES:

Elements composing a quality loan can vary in an individual case, but certain common concerns and issues repeatedly appear in competent and reliable credit analyses in certain industries.

A review of our current portfolio of biobased loans indicates common credit issues are inherent to agriculture related business, including the biobased industry. Some common issues include (1) the fluctuating price for raw material/inventory (corn, soybeans, etc.) affected significantly by local incentives to supply the product, (2) the demand for the end product is driven by State and Federal regulations and the price to the consumer, and (3) the high cost of production. There is no reliable tool to predict or control the pricing and availability of the raw material. It is impossible to predict the future interests of State and Federal legislators and the possible State mandates or subsidy assistance available to biobased ventures. While reviewing financial projections based on best-case and worst-case scenarios provides some realization of the volatility of the industry, these scenarios are usually prepared using historical industry data and short-term future predictions for long-term loans. Therefore, you may allow significant variance for the ability of new businesses to meet projections and existing businesses to perform at significantly greater capacity and achieve an increased profit. Additional guidance is being provided to ensure B&I Guaranteed Loan Program credit quality and consistency are maintained when reviewing such proposals.

RD Instruction 4279-B, section 4279.131, states: "The lender is primarily responsible for determining credit quality and must address all of the elements of credit quality in a written credit analysis including adequacy of equity, cash flow, collateral, history, management, and the current status of the industry for which credit is to be extended."

1. Credit Quality - In analyzing loans for the biobased industry, good credit analysis requires that special attention be given to the following underwriting criteria:
 - a. Cash Flow/Loan Term
RD Instruction 4279-B, section 4279.131(a), states: "All efforts will be made to structure or restructure debt so that the business has adequate debt coverage and the ability to accommodate expansion." To ensure there is adequate debt coverage, the term of the proposed B&I loan must take into consideration the extent that the biobased project is dependent on Federal or State subsidies. An analysis of cash flow should include adjustments

removing any temporary tax credits or incentives to reflect a more accurate financial picture of the business' ability to repay the debt from the operation of the business. For example, the current \$0.10 per gallon income tax credit for the production of ethanol by small producers, established under the Clean Air Act of 1990, will expire on December 31, 2007.

b. Collateral

Collateral must have documented value sufficient to protect the interest of the lender and the Agency. Experience indicates that a discounted value of no more than 65 percent of the appraised value of real estate and 50 percent of machinery and equipment should be allowed in accordance with section 4279.131(b)(1). The discounted collateral value will normally be at least equal to the loan amount. Exceptions may be approved by the Administrator for purchase-money-interest equipment liens or other circumstances with reasonable justification.

c. Equity

RD Instruction 4279-B, section 4279.131(d), establishes minimum equity requirements for new and existing businesses. Section 4279.131(d)(3) specifically identifies energy-related businesses as riskier and will require a higher tangible balance sheet equity requirement. At a minimum, biobased loans will need 40 percent tangible balance sheet equity at the time the Loan Note Guarantee is issued. The determination will be made using financial statements prepared by a certified public accountant in accordance with Generally Accepted Accounting Principles to ensure the integrity of the statements.

d. Feasibility Study

A feasibility study prepared by a qualified, independent consultant will be required for all biobased proposals, regardless of whether the business is new or existing. The consultant should have credentials and experience in biobased industries. The feasibility study must address economic, market, technical, financial, and management feasibility and integrate these findings to reach an overall conclusion concerning feasibility of the proposal. While addressing the content of RD Instruction 4279-B, Appendix A, the feasibility study should address the following additional issues:

- (1) The local production and supply of the agricultural commodities for the biobased product.
- (2) The presence or absence of sufficient storage facilities to hold the commodities not immediately processed.
- (3) An analysis of why the proposed manufacturing technology is the appropriate choice for the project, e.g., wet milling vs. dry milling in ethanol production.
- (4) An analysis of the financial impact of all Federal, State, and local government subsidies that will support the business, including a discussion of their nature and likelihood to continue.
- (5) An investigation into whether the organizational structure of the business will or will not allow it to take advantage of the subsidies that are available.
- (6) Risk analysis of the business projections, presenting both a most likely case and multiple cases where governmental subsidy is terminated.
- (7) Discussion of location concerns, including the costs and efficiency of transporting agricultural commodities to the plant and subsequent delivery of the manufactured products or by-products to market.
- (8) The presence of markets and specific buyers for the biobased products and by-products.
- (9) The presence of existing and planned competitors both inside and outside the State. The impact of the higher or lower subsidies available to competitors in other States.

2. Expertise - While credit quality is mainly used to determine the risk associated with a proposal, the experience and expertise of the evaluators are as important.
 - a. Technical Assistance

State Offices may request assistance on loans within their delegated authority. The National Office will provide contact names and phone numbers, as appropriate, for expert advice from the Department of Energy; Department of Agriculture Office of Energy Policy, Forest Service, and Natural Resource Conservation Service; the Environmental Protection Agency, etc.
 - b. Lender

A lender must have experience with biobased lending to provide the level of complex analysis needed for this type of credit. RD Instruction 4279-A, section 4279.29(c), states: "Expertise. Loan guarantees will only be approved for lenders with adequate experience and expertise to make, secure, service, and collect B&I loans." Therefore, as part of any application or preapplication, a lender proposing to make a loan to a biobased manufacturer should provide evidence of their "adequate experience and expertise" to make sound decisions on biobased proposals. The Agency must first approve the adequacy of the lender's expertise in biobased lending before it encourages any complete applications from the lender. Attachment A is a tool that may be used to document a lender's expertise in biobased lending.
 - c. Feasibility Study Analyst

In accordance with RD Instruction 4279-B, section 4279.150 and Appendix A, a qualified independent consultant will be required to complete the feasibility study. The consultant must be approved by the Agency. Attachment B is a guide to document your approval of the feasibility study analyst.

- d. Appraiser
RD Instruction 4279-B, section 4279.144, requires appraisals to comply with Standards I and II of the Uniform Standards of Professional Appraisal Practices (USPAP). In accordance with the competency requirement of Standard II of USPAP, the appraiser must have the necessary experience and certification to complete the appraisal. Biobased product facilities are specialized in nature, and the appraisal must be completed by an appraiser with the qualifications to determine the actual value of the collateral. The appraiser should have specific experience and certifications in valuing similar specialized assets.
- e. Planning and Performing Development
In accordance with RD Instruction 4279-B, section 4279.156, all project facilities must be designed utilizing accepted architectural and engineering practices and conform to applicable Federal, State, and local codes and requirements. Due to the specialized nature of biobased facilities, it appears that the use of an independent professional to design and estimate the cost of development is the only method which assures that regulation requirements are achieved. Additionally, the lender should have progress inspections made by a qualified individual, as required by RD Instruction 4279-B, section 4279.156(b).

In summary, by adopting this comprehensive approach on biobased proposals, the B&I Guaranteed Loan Program, partnering with the lender, will have reasonable assurance that sustainable economic benefits, biobased product sources of energy, and environmental benefits are realized. Proponents of biobased projects should be advised of these guidelines so they have a clear understanding of the role the B&I program can play in the industry.

Any exceptions to the above guidance must be approved by the Administrator. Any request for exception should include a detailed justification for the request.

If you have any questions, please contact Business Programs Assistant Deputy Administrator Pandor Hadjy, (202) 720-0813.

(Signed by John Rosso)

JOHN ROSSO
Administrator
Rural Business-Cooperative Service

Attachments

ATTACHMENT A

Documentation of Lender Expertise for Biobased Manufacturing Loans

State: _____

— Name, address, phone, fax, web site, and e-mail of contact:

— List all non-B&I loans to biobased manufacturing businesses:

— List all biobased manufacturing loans in the lender’s portfolio, date of loan, loan size, and status:

- List all loan officers who will be responsible for underwriting biobased manufacturing loans. Attach a resume for each, including specific biobased lending experience.

- List any consultants or industry experts that will be used to analyze or service biobased manufacturing loans.

- List any other pertinent information to document the lender's expertise in biobased lending.

ATTACHMENT B

**Documentation of Feasibility Study Analyst Expertise
for Biobased Manufacturing Loans**

State: _____

— Name, address, phone, fax, web site, and e-mail of primary analyst:

— List all biobased manufacturing proposals completed or consultation given and the current status of the business/company (in operation or not).

— Attach resumè detailing experience with specific emphasis on biobased projects.

— Provide three references who can verify/support expertise:

1.

2.

3.
